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## Chapter 7 Possession Corporations

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### Section 7.1 Possessions Corporations - The Federal Rules

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#### ***References:***

Revenue and Taxation Code §25110(a)  
California Code of Regulations §25110(d)  
Internal Revenue Code §936  
Treasury Regulation §1.936

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### ***Training Objectives:***

This section of the Water's-Edge Manual provides an analysis of the federal rules and regulations applicable to electing possessions corporations, Internal Revenue Code (IRC) §936. A working knowledge of IRC §936 is required to effectively examine the California combined report of a multinational corporation with a possessions corporation.

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### **a. *The History Of IRC §936***

The United States has offered tax incentives to invest in its possessions since 1921. IRC §251, enacted by the Revenue Act of 1921, excluded from federal taxable income the income earned by a domestic corporation operating in a United States possession, particularly Puerto Rico. Subsequently, the 1954 IRC added Subpart D and renumbered IRC §251 to IRC §936. The section was unchanged by these 1954 amendments. In 1963 Puerto Rico enacted the Puerto Rico Industrial Incentives Act of 1963. The benefits created by the combination of IRC §936 and the Puerto Rico Industrial Incentives Act resulted in tremendous economic growth in Puerto Rico, lasting well into the early 1970s.

IRC §936 was significantly changed by the Tax Reform Act of 1976 (TRA76).<sup>1</sup> TRA76 eliminated the exclusion of income earned in Puerto Rico. Instead, it replaced the exclusion of income with a "Possessions Tax Credit", equal to the federal tax on certain income earned by the possessions corporation. TRA76 also added a dividends received deduction for the shareholder.

Six years later the Tax Equity and Fiscal Responsibility Act of 1982<sup>2</sup> (TEFRA82) added IRC §936(h), tax treatment of intangible property income. IRC §936(h) allows for a 50-50 split between the possessions corporation and its United States affiliates of the profits from manufacturing intangibles employed in Puerto Rico. That is, 50 percent of the profit is reported on the return of the United States affiliates and is therefore not eligible for the Possessions Tax Credit. This amendment was made because of the controversy surrounding intercompany transfer pricing between possession corporations and their United States affiliates.

The next major change to IRC §936 took place in 1993. For income years beginning after December 31, 1993, Congress enacted the Omnibus Budget Reconciliation Act of 1993 (OBRA93),<sup>4</sup> which imposed limits on the possessions tax credit. IRC §936(a)(4) allows the possession corporation to either calculate its credit limitation based on a formula or elect to apply a specified percentage limitation.

The Small Business Job Protection Act of 1996 dealt the final blow to the Possessions Tax Credit by repealing IRC §936 for taxable years after December 31, 1995. However, broad phase-out rules were provided for existing credit

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claimants. Taxpayers qualifying as existing credit claimants will still be able to claim the credit to a limited extent until 2006.

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### ***b. In General***

The purpose of this section of the Water's-Edge Manual is to provide a general technical overview of IRC §936. Subpart D of the IRC contains specific rules under which United States corporations operating in United States possessions, Puerto Rico or the Virgin Islands, pay no federal income tax on qualifying income earned within the possession. On the average, the income tax paid by a possessions corporation to the possession country is less than five percent of net income.

An electing possessions corporation is generally taxed on its worldwide income in a manner similar to any other United States corporation. However, IRC §936 provides a special tax credit for certain income of certain United States corporations operating in Puerto Rico or the Virgin Islands. Currently, there are approximately 500 electing possessions corporations, the majority of which are manufacturing. The primary benefactors from the possessions tax credit include pharmaceutical companies, certain electronic companies and software development companies. An electing possessions corporation must file a separate federal Form 1120. It cannot file a consolidated federal tax return.

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### ***c. The IRC §936 Election***

The benefits of IRC §936 are limited to domestic corporations which elect the application of this code section. The election is made by filing federal Form 5712, "Election to be Treated as a Possessions Corporation under Section 936", with the Internal Revenue Service's (IRS) Philadelphia Center on or before the due date or extended due date of the corporation's federal tax return for the first year the election is to be applicable. The election is filed separately from the federal tax return and cannot be made with an amended return. The election became available for income years beginning on or after December 31, 1975.<sup>5</sup> Refer to the Forms Appendix for a copy of federal Form 5712.



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### ***d. The IRC §936 Election Terms***

The election is made for an initial period of ten years. Generally, the election cannot be revoked without permission from the IRS.<sup>6</sup> However, it is anticipated that consent would be granted in the case where the taxpayer can demonstrate substantial hardship. Once the initial ten-year period expires, the election may be revoked at any time without the consent of the IRS. The request for revocation of an election must be made in writing.<sup>7</sup> Subsequent elections can be made for any income year thereafter.

The IRC §936 election will automatically remain in effect until either it is: (1) revoked; (2) the corporation fails to meet the 80 percent possessions source gross income test or the 75 percent possessions active trade or business test; (3) the corporation becomes a Domestic International Sales Corporation (DISC) or a Foreign Sales Corporation (FSC); or, (4) the corporation owns stock in a DISC, a former DISC, a FSC or a former FSC.

If a possessions corporation fails to meet either the possessions source gross income test or the possessions active trade or business test for any income year, the Secretary is authorized under certain circumstances to allow the corporation to make a pro rata distribution of property to its shareholders in an amount equal to the reduction in nonqualifying gross income necessary to retroactively satisfy both the 80 percent and 75 percent qualification tests. Thus, the possessions corporation can rectify the situation and claim its possessions tax credit.

The statute implies that there is no time limit as to when the distributions must occur to satisfy the test in question as long as the possessions corporation's failure to satisfy the test is not due to willful neglect or fraud.<sup>8</sup>

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### **e. *Eligible Corporations***

The IRC §936 credit is available to any electing domestic corporation that satisfies both the 80 percent possessions source gross income test and the 75 percent possessions active trade or business test. These tests are applied to the three-year period immediately preceding the close of the tax year (or the applicable part thereof).<sup>9</sup> Treasury Regulation (TR) §1.613(a) defines gross income in a sales or manufacturing setting as: total sales less cost of goods sold; income from investments; and any income from other operations or sources. Items normally excludable from gross income by virtue of specific code provisions, to the extent applicable to corporations, are not taken into account in computing gross income for purposes of these tests.<sup>10</sup>

Also, gross income received on the mainland by a possessions corporation is only considered possessions source income if it is derived from the trade or business with an unaffiliated party.<sup>11</sup> If a United States affiliate deposits a payment into a possessions corporation's bank account on the mainland as payment for goods manufactured by that possessions corporation, then the payment will not be considered possessions source income of the possessions corporation.<sup>12</sup> The possessions corporation must receive payment in the possession country for goods and services in order for the payment to be considered possessions source income that qualifies for the IRC §936 tax credit. Further, for the sale of inventory sold into the United States, the title of the goods must pass in the possession country to create possessions source income in that possession.<sup>13</sup>

#### **1. *Test Period***

The test period is the three-year period prior to the year-end.<sup>14</sup> For example, assume Corporation A, a calendar year-end taxpayer, wants to claim the possessions tax credit in 1995. Corporation A has not filed a short-period return within the last five years. Corporation A's test period would include the 1993, 1994 and 1995 income years.

Assume instead that Corporation A filed a return for the short-period of January 01, 1993, to August 31, 1993, and another short-period return for September 01,

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1993, to December 31, 1993. Corporation A's test period would include both of the 1993 filings and the 1994 and 1995 income year filings.

Lastly, assume that Corporation A started doing business on February 01, 1994. Corporation A's test period would only include the 1994 (February 01 to December 31) and 1995 income year filings. The fact that Corporation A was not in existence for the entire three-year period does not preclude the corporation from qualifying for the credit. The test period would consist of that portion of the three-year period that the corporation did operate.<sup>15</sup>

### 2. Possessions Source Gross Income Test

For the three-year test period, at least 80 percent of the gross income of the electing corporation must be derived from sources within a possession of the United States. This income test is determined without regard to IRC §904(f), which relates to the recapture of foreign losses.<sup>16</sup>

Example 1:

A domestic corporation has gross income of \$900,000 in 1994, including \$702,000 from the sale of goods from the active conduct of a trade or business in a United States possession (net of the cost of goods sold), \$63,000 of Qualified Possession Source Investment Income (QPSII), and \$135,000 of other income not qualifying as possessions source income. The corporation reported gross income from the preceding two years as follows:

Year	Gross Income	<u>Sale of goods from active conduct of trade/business in U.S. possession (net of COGS)</u>	QPSII
1993	\$400,000	\$308,000	\$20,000
1992	\$550,000	\$418,000	\$30,000

Answers:

Year	Gross Income	<u>80%</u>	<u>Possessions Source Income</u>
1994	\$900,000	\$720,000	\$765,000

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1993	\$400,000	\$320,000	\$328,000
1992	\$550,000	\$440,000	\$448,000

Since at least 80 percent of the "gross income" for each of the income years within the test period (the three-year period immediately preceding the close of the current tax year) was derived from sources within a United States possession, the corporation satisfies the 80 percent possessions source gross income test.

### ***3. Possessions Active Trade Or Business Test***

For the same three-year test period, at least 75 percent of the gross income of the electing corporation must be derived from the active conduct of a trade or business in a United States possession.<sup>17</sup>

Example 2:

Assuming the same facts as in Example 1, does the domestic corporation also meets the 75 percent possessions active trade or business test?

Year	Gross Income	75%	Active Business Income
1994	\$900,000	\$675,000	\$702,000
1993	\$400,000	\$300,000	\$308,000
1992	\$500,000	\$412,500	\$418,000

Since at least 75 percent of its gross income was derived from the active conduct of a business in a possession country for each of the income years within the test period (the three-year period immediately preceding the close of the current tax year), the corporation satisfies the 75 percent possession active trade or business test.

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### ***f. The Allowed IRC §936 Credit***

The allowable credit pursuant to IRC §936 equals the portion of the tax attributable to the sum of the following components of taxable income:

- 1) Foreign sourced taxable income from the active trade or business conducted within a U.S. possession;
- 2) Foreign sourced gain from the sale or exchange of substantially all the assets used in the possession trade or business; and
- 3) QPSII.<sup>18</sup>

QPSII is the gross income from sources within the United States possession in which a trade or business is actively conducted, to the extent that the taxpayer establishes to the satisfaction of the Secretary that the income is attributable to the investment in such possession (for use therein) of funds derived from the active conduct of a trade or business, or from such investment, less the deductions properly apportioned or allocated thereto.<sup>19</sup>

In general, income earned by the possessions corporation in the possession country will be allowed the possessions tax credit. Interest earned by a possessions corporation actively engaged in a trade or business in such possession will be treated as QPSII if the interest qualifies for exemption from the possession income tax and the funds, with respect to which the interest is earned, are from the active conduct of a possession trade or business or from investment of such funds.<sup>20</sup>

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### ***g. Interaction With Other IRC Sections***

The IRC §936 credit is in-lieu of the usual IRC §901 foreign tax credit or any deduction for foreign taxes paid or accrued on QPSII. In addition, any taxes paid to a foreign country by a possessions corporation with respect to income taken into account in determining the possessions tax credit cannot be deducted and cannot be considered when computing the foreign tax credit.<sup>21</sup> For purposes of computing the foreign tax credit, both the numerator and the denominator of the limiting fraction are reduced by the amount of income taken into account to compute the possessions tax credit.

The IRC §936 tax credit is not available for use against the environmental tax,<sup>22</sup> the tax on accumulated earnings,<sup>23</sup> the personal holding company tax,<sup>24</sup> or taxes arising out of recoveries of foreign expropriation losses.<sup>25</sup>

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### ***h. Taxation Of Paid Dividends***

Generally, a dividend paid by a possessions corporation to its United States parent corporation will be eligible for the 100 percent dividend received deduction, assuming the possessions corporation is owned at least 80 percent by the United States parent corporation.<sup>26</sup>

Also, the possessions corporation shareholder(s) get no deduction or foreign tax credit for any foreign or possessions tax paid or accrued with respect to any distribution from a possessions corporation where the recipient is entitled to the corporate dividend received deduction or where the distribution is connected with a liquidation or other transaction on which gain or loss is not recognized for United States tax purposes.<sup>27</sup>

In the case of a dividend paid by a possessions corporation to a foreign shareholder, the dividends received will generally be treated as foreign source income, not effectively connected with a United States trade or business.<sup>28</sup> However, any distribution that meets the qualification requirements of IRC §936(a)(2) will be treated as United States source income to the foreign shareholder.<sup>29</sup>

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### *i. Qualified Possession Countries*

The United States possessions in which an electing corporation can obtain the benefits of IRC §936 include the Commonwealth of Puerto Rico and the Virgin Islands.<sup>30</sup> The Virgin Islands were added to the definition of a qualified possession country by the TRA86. However, Puerto Rico continues to be the possession country in which the majority of possessions corporations operate.

### *j. Claiming The IRC §936 Credit*

The possessions tax credit is claimed by completing federal Form 5735, Computation of Possessions Corporation Tax Credit, and attaching it to the electing possessions corporation's federal Form 1120. Refer to the Forms Appendix for a copy of federal Form 5735.



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### ***k. Special Rules And Limitations***

The IRC §936 credit has several important rules and limitations.

- 1) The credit cannot be taken by any corporation for any taxable year in which it is a DISC or former DISC, or in which it owns at any time the stock in a DISC, a former DISC, a FSC or a former FSC.<sup>31</sup>
- 2) For purposes of IRC §936, taxable income of the possessions corporation cannot take into account as income from sources without the United States any gross receipts received by the electing domestic corporation in the United States, regardless of the source of the income. The only exception to this rule is that trade or business income from unrelated persons can be received within the United States.<sup>32</sup> This rule has served as a trap for the unwary tax planner. For example, funds received first by a possessions corporation in its principal office in Puerto Rico and subsequently deposited in a United States bank are considered to have been received outside the United States.<sup>33</sup> These funds would be classified as possessions source income. However, if a bank, acting as an agent for the possessions corporation, collects funds in the United States due to the possessions corporation, then these funds are considered to have been received in the United States first, regardless of whether or not the bank immediately credits these funds to the possessions corporation's account with the branch of the bank located in the possession country. These funds would not be classified as possessions source income. These funds would instead be classified as United States source income.
- 3) Income from the sale or exchange of assets with a substitute basis does not qualify as non-United States sourced taxable income or QPSII unless the asset was held at all times by the taxpayer governed by IRC §936, IRC §931 or §857 of the 1954 IRC.<sup>34</sup>
- 4) The allowable credit cannot be applied against the environmental tax, the tax on accumulated earnings, the personal holding company tax or the tax on recoveries of foreign expropriation losses.<sup>35</sup>
- 5) Any taxable income of a possessions corporation which is eligible for the IRC §936 credit is not includible in the accumulated taxable income for purposes of computing the accumulated earnings tax pursuant to IRC §531. Also, any assets which generate such taxable income are treated as held for the reasonable needs of the business for purposes of IRC §531.<sup>36</sup>

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### ***I. Intercompany Transfer Pricing***

Aspects of intercompany transfer pricing are fully discussed in Chapter 18, Water's-Edge Manual. This section briefly discusses the transfer pricing issue that specifically effects possessions corporations. Most audits with a possessions corporation, due to the nature of the tax-free provisions, contain a potential pricing issue in relation to an intangible asset. The IRS will not be auditing transfer pricing issues for possessions corporations electing to use the profit split method. Accordingly, federal activity in this area should not be followed.

#### ***1. Background***

Before 1982, there were no explicit statutory guidelines on how to allocate income generated by intangible assets, such as patents, trade names and trademarks between affiliated corporations. As a result, many domestic corporations attempted to increase their tax-exempt income by transferring intangible assets, created in the United States, to affiliated possessions corporations. The expenses associated with the creation of the asset were deducted by the United States affiliate during the development phase. The income stream associated with the transferred intangible asset was effectively exempted from taxation by applying the provisions of IRC §936.

Many affiliated corporate groups construed the law to require no allocation of income generated by the intangible asset to the United States affiliate. In contrast, the IRS construed the law to require an allocation of income to United States affiliates, applying IRC §482. As a result, these two opposing views have been repeatedly litigated.

The issue of income allocation evolves from the differing tax treatment afforded transfers between two United States corporations and transfers between a United States and a foreign corporation. Because foreign source income of a foreign corporation normally is not subject to United States tax, United States shareholders would take advantage of the tax-free provisions of IRC §351 and transfer income producing assets (the developed intangible property) to foreign subsidiaries. IRC §367 was enacted to minimize this perceived abuse.

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IRC §367 provided that to receive the benefits offered by this nonrecognition provision (IRC §351), the United States corporation making such a transfer had to obtain a ruling from the IRS that the transfer was not undertaken for the principal purpose of avoiding United States tax. In some instances, the IRS imposed a "toll charge" on the transfer of the property to the foreign corporation where tax avoidance was a primary reason for the transfer.<sup>37</sup> However, transfers between two United States corporations, such as transfers between a United States corporation and a possessions corporation, are not covered by IRC §367. Thus, intangible assets could be transferred to a possessions corporation applying the tax-free provisions of IRC §351 and not be governed by IRC §367.

The transfer of intangibles by a United States developer to a possessions corporation has been repeatedly litigated by the IRS. The IRS argued that distortion resulted when research and development expenses were deducted in the United States by the developer of the intangible, while the related income stream was transferred and subsequently sourced to the possession country. In the early 1970s, the IRS intensified its examinations of possessions corporations. Treating this as a coordinated examination issue, the IRS began using a staff of economists to pursue intercompany pricing issues pursuant to IRC §482. The IRS examined the relationship between a United States parent corporation and its possession-based affiliate. In many cases, the IRS asserted that the possessions corporation was nothing more than a contract manufacturer. As such, the possessions corporation should only be entitled to a reasonable return for this service. It was not entitled to any profit attributable to the intangible property associated with the product or service, regardless of the fact that the intangible property was transferred to the possessions corporation. The income would then be allocated to the United States affiliate.

Despite the expansive authority granted by IRC §482 to make allocations between the United States corporation and its possessions corporation to properly reflect income, the IRS was not successful with this contract manufacturing theory. Rather than accepting the IRS's contract manufacturing argument, the Tax Court in the cases of *Eli Lilly & Company v. Commissioner*<sup>38</sup> and *G.D. Searle and Company v. Commissioner*<sup>39</sup> effectively split the profits attributable to the intangibles between the United States corporation and the possessions corporation.

Considering the materiality of this issue and the IRS's difficulty in court, a legislated resolution was developed with the enactment of IRC §936(h) by

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TEFRA82. Effective for income years beginning after December 31, 1982, an electing possessions corporation can elect to attribute some of the intangible property income to the United States corporation by use of either the cost sharing method or the profit split method. If neither election is made, virtually all of the income stream attributable to the intangibles is considered United States source income, not eligible for the possessions tax credit.

IRC §936(h) attempts to allocate income derived from intangible property back to the entity that created it. However, it also provided a "safe haven" vehicle to determine intercompany profits, by providing a way to elect certain optional pricing methods. These revisions were meant to minimize the amount of profits spun off to the possessions corporation.

TRA86 also made revisions to IRC §482 by introducing the new concept of a "commensurate with income" standard. That is, the income reported by a corporation from an intangible asset should be commensurate with the research and development employed by that corporation.

### ***2. Definition Of Intangible Property Income***

The term "intangible property income" is defined as a possessions corporation's gross income attributable to any intangible property, other than intangible property which was licensed to such corporation prior to 1948 and was in use by the corporation on September 3, 1982.<sup>40</sup> Intangible property income does not include income from the sale of products or from services by the possessions corporation when a reasonable return is derived. A reasonable return is the reasonable direct and indirect costs it incurred in connection with intangibles, plus a reasonable profit margin.<sup>41</sup>

Intangible assets include:

- Patents, inventions, formulas, processes, designs, patterns and know-how;
- Copyrights and literary, musical or artistic compositions;
- Trademarks, trade names or brand names;
- Franchises, licenses or contracts;
- Methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- Any similar item.<sup>42</sup>

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### ***3. General Rule For Intangible Property Income***

Profit derived from all intangible property owned or licensed by the possessions corporation is generally allocated to the possessions corporation's shareholders, based on percentage of ownership<sup>43</sup> and is treated as United States source income.<sup>44</sup> An exception is provided if the possessions corporation elects to use either the cost sharing method or the profit split method to determine the intercompany income from intangible property.

Further, intangible property income is not allocated to any possessions corporation's shareholder if they are a foreign person or are not subject to tax under the IRC on such income. Where intangible property income is not allocated, the intangible property income is taxed to the possessions corporation as United States source income and is not taken into account in computing the 80 percent possessions source gross income test or the 75 percent possessions active trade or business test. This income does not qualify for the IRC §936 tax credit.<sup>45</sup>

Intangible property income is taxable to the United States shareholder in the year allocated. This allocation is made whether or not the shareholder actually receives the income. Income attributable to intangible property includes any income received by a possessions corporation from the sale, exchange or other disposition of products or services which exceeds a reasonable profit margin. A reasonable profit margin is computed with respect to direct and indirect costs other than (i) costs incurred in connection with intangibles; (ii) interest expense; and (iii) the cost of materials which are subject to processing or which are components in a product manufactured by the possessions corporation.<sup>46</sup>

The effect of the general rule is to treat a possessions corporation as a contract manufacturer not owning any intangible property, even if the intangible property was purchased from unrelated parties or developed by the possessions corporation itself. Also, the general rule may result in a greater portion of the possessions income being allocated to the United States corporation where significant manufacturing or marketing intangibles are involved.

Again, the income allocated to affiliates would be excluded from the computation of the 80 percent possessions source gross income test, the 75 percent

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possessions active trade or business test and would not be eligible for the foreign tax credit.

### ***4. Optional Pricing Methods: Cost Sharing Or Profit Split***

Effective for income years beginning after December 31, 1982, an electing possessions corporation had to elect to use either the cost sharing method or the profit split method, or virtually all of the income attributable to the intangibles would be considered United States source income, not eligible for the possessions tax credit.

The two optional pricing methods are the cost sharing method and the profit split method.<sup>47</sup> The possessions corporation must attach federal Form 5712-A, Election and Verification of the Cost Sharing or Profit Split Method Under Section 936(h)(5), to its federal Form 1120. Refer to the Forms Appendix for a copy of federal Form 5712-A. To use one of these two optional pricing methods, the possessions corporation must affirmatively elect out of the general arm's length pricing methodology. It may either elect the cost sharing method or the profit split method to compute its taxable income.

To apply either of these two alternatives, the possessions corporation must first satisfy a significant business presence test with respect to the product it produces or the service it renders.<sup>48</sup> If the possessions corporation elects the profit split method with respect to the production of a product, the significant business presence test also includes a "substantial transformation of property" test with respect to its manufacturing operations. The election out of the general pricing method is made on a product-by-product, or service-by-service basis. Thus, a possessions corporation could have more than one line of business and report each on a different basis. If the significant business presence test is not met with respect to one or more of the product lines, that product line is not eligible for the cost sharing or profit split method so the general rule must be used.

For income years beginning after December 31, 1986, the cost sharing method must be commensurate with the income attributable to the intangible asset, while the profit split method is simply an equal split of the profits.

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California does not have a provision similar to IRC §936(h). Rather, Revenue and Taxation Code §24725 conforms to IRC §482 and is the controlling code section when income and expense items must be re-allocated among members of an affiliated group in order to clearly reflect income.

As a result, an arm's length share of income arising from an intangible, developed by a water's-edge group member, is attributed to the developer under the commensurate with income standard of IRC §482. The regulations implementing the commensurate with income standard provide for "periodic adjustments" to the royalty rates established at the time the intangible was transferred to take into consideration the income actually generated by the intangible in years subsequent to the transfer. Prior to enactment of the commensurate with income standard, such periodic adjustments were generally not allowed by the courts. If the intangible asset was developed by a United States corporation, this reallocation of intangible property income would increase apportionable net income of the water's-edge group with no corresponding increase or decrease in the apportionment factors of the group.

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### ***m. Recent Developments In Federal Law***

The federal §936 possession tax credit is being phased out. First, the §936 credits were significantly limited by the Omnibus Budget Reconciliation Act of 1993. Then, the Small Business Job Protection Act of 1996 began a phase-out process that will terminate the credit completely by 2006.

#### **Omnibus Budget Reconciliation Act of 1993.**

The Clinton Administration passed legislation within the federal budget packet, OBRA93, which limited the allowable possession tax credit. For income years beginning after December 31, 1993, a possession corporation has two options. Under the "Economic Activity Limit" method, the credit for any taxable year cannot exceed the sum of the following:

Sixty percent of the possession corporation's qualified possessions wages, plus the allocable employee fringe benefit expenses; plus  
Specified percentages of the possession corporation's depreciation expense with respect to qualifying tangible property.

Or, the possessions corporation can elect within its first year after December 31, 1993 to apply the "Percentage Limitation" method. Under this method, the §936 credit is limited to a specified percentage of the otherwise allowable credit amount. The allowable amount of the credit decreases from 60 percent to 40 percent over a five year period. The applicable percentage limitation for any income year beginning in 1994 is 60 percent; in 1995 is 55 percent; in 1996 is 50 percent; in 1997 is 45 percent; and in 1998 and thereafter, the rate is 40 percent. Note that the IRC §936 tax credit for any QPSII is not limited.<sup>49</sup>

#### **Example 3:**

For the income year beginning April 1, 1995, Rico Corporation, a possession corporation, has active business income from the possession based operations of \$900,000. Rico also has QPSII of \$100,000. Without the IRC §936 tax credit, Rico's United States tax liability on this income would be \$315,000 and \$35,000, respectively. However, Rico's IRC §936 tax credit is now limited to \$208,250. This is comprised of \$173,250 (\$315,000 X 55%) related to the active business income plus \$35,000, the full amount of the credit applicable to the QPSII.



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### **Small Business Job Protection Act of 1996.**

For tax years beginning after December 31, 1995, the possession tax credit is repealed except for corporations that qualify as "existing credit claimants." In general, an existing credit claimant is a corporation that has elected the benefits of §936 for its tax year which includes October 13, 1995, and which is engaged in the active conduct of a trade or business within a possession on that date. However, if an existing credit adds a substantial new line of business after October 13, 1995, it will cease to be treated as an existing credit claimant, which means that it will no longer be entitled to claim the credit.

An existing credit claimant that uses the economic activity limitation under §936(a)(4)(A) will continue to determine its §936 credit under that method for taxable years beginning before January 1, 2002. Beginning in 2002, the possession income eligible for the credit will be subject to a cap. The credit will be terminated completely for taxable years beginning after December 31, 2005. (Note: For businesses conducted in Puerto Rico, IRC §30A contains some additional provisions regarding the application of the §936 phase-out rules.)

An existing credit claimant that uses the Percentage Limitation method under §936(a)(4)(B) will continue to use that method for taxable years beginning before January 1, 1998. Beginning in 1998, the possession income eligible for the credit will be subject to a cap. The credit will be terminated completely for taxable years beginning after December 31, 2005.

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### *n. Summary*

IRC §936 elections offer significant tax planning opportunities to virtually any corporate group with a United States filing requirement. Effectively, the possession corporation election remains one of the most substantial United States sanctioned tax-haven provisions currently available. By allowing a credit against federal tax equal to the tax on qualified possessions source income earned by a qualified electing domestic corporation, the United States effectively encourages corporations to operate and invest in United States possession countries. Although recent events have resulted with a reduced credit, the tax savings are still worthwhile for these corporations to pursue the benefits of IRC §936.

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### **Footnotes**

1. Public Law (PL) 94-455, dated October 04, 1976.
2. PL 97-248, dated September 03, 1982.
3. Not Used
4. PL 103-66, dated August 10, 1993.
5. Treasury Regulation (TR) §1.936-1(a).
6. TR §1.936-7(c).
7. TR §1.936-1(b).
8. IRC §936(h)(4)(A) & (B); TR §1.936-7(a) Q&A 7.
9. IRC §936(a)(2)(A). IRC §936(a)(2)(B).
10. TR §1.936-6(b)(1), question 5. *The Possessions Corporation Tax Credit Under Section 936, Tax Management Foreign Income Portfolios (BNA) No. 993*, by Ernest F. Aud, Jr., Esq., page A-58.
11. IRC §936(b).
12. *Pacific Basin Mfg. & Trade Company v. Commissioner*, 716 F.2d 638 (9th Circuit 1983). Revenue Ruling (RR) 79-168, 1979-2 Cumulative Bulletin (CB), page 283.
13. IRC §865(b).
14. IRC §936(a)(2)(A).
15. *Ibid.*, note #14.
16. *Ibid.*, note #14.
17. IRC §936(a)(2)(B).
18. IRC §936(a)(1)(A). IRC §936(a)(1)(B).
19. IRC §936(d)(4)(A).
20. Temporary TR §7.936-1.
21. IRC §901(g).
22. IRC §936(a)(3)(A). IRC §59A.
23. IRC §936(a)(3)(B). IRC §531.
24. IRC §936(a)(3)(C). IRC §541.
25. IRC §936(a)(3)(D). IRC §1351.
26. IRC §243(b)(1).
27. *Ibid.*, note #21.
28. IRC §936(h)(1). IRC §936(h)(2).
29. IRC §936(h)(4)(B).
30. IRC §936(d)(1)(B).
31. IRC §936(f).
32. IRC §936(b).
33. RR 79-268, 1979-2 CB, page 283.

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34. IRC §936(d)(3)(A). IRC §936(d)(3)(B).
  35. IRC §936(a)(3).
  36. IRC §936(g).
  37. Revenue Procedure 68-23, 1968-1 CB, page 821.
  38. 84 Tax Court (TC) 996 (1985), revised in part, affirmed in part and remanded, No. 86-2911 and No. 86-3116 (7th Circuit, August 31, 1988).
  39. 88 TC 252, 376 (1987).
  40. IRC §936(h)(3)(A).
  41. IRC §936(h)(3)(C).
  42. IRC §936(h)(3)(B). Senate Report (SB) No. 97-494, Volume 1 (PL 97-248), page 162.
  43. IRC §936(h)(1)(A).
  44. IRC §936(h). SB No. 97-494, Volume 1 (PL 97-248), page 160.
  45. IRC §936(h)(2).
  46. TR §1.936-4, Question 3.
  47. IRC §936(h)(5)(C); TR §1.936-6
  48. IRC §936(h)(B); TR §1.936-5(b)
  49. IRC §936(a)(4).

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### **Section 7.2 Possessions Corporation - IRC §936 v. The Unitary Method**

#### ***Contents:***

- a. Introduction
- b. Worldwide Combined Reporting
- c. Water's-Edge Combined Reporting
- d. Identifying Possessions Corporations
- e. Possessions Corporations With A 20 Percent Or More Average United States Factor
  - 1. In General
  - 2. Property Factor
  - 3. Payroll Factor
  - 4. Sales Factor
- f. Possessions Corporations With Income Effectively Connected With A United States Trade Or Business
- g. Intercompany Transfer Pricing
  - 1. In General
  - 2. Required Audit File Analysis
  - 3. Profit Split Method
  - 4. Cost Sharing Method
- h. Dividends Paid By A Possessions Corporations
- i. Summary

#### ***References:***

Revenue and Taxation Code §25110(a)  
California Code of Regulations §25110(d)  
Internal Revenue Code §936

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### ***Training Objectives:***

Upon completion of this section of the Water's-Edge Manual, you will have a basic understanding of the California laws and regulations that are affected by Internal Revenue Code (IRC) §936.

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### ***a. Introduction***

After completing Section 7.1, Water's-Edge Manual, you now have a basic understanding of how the possessions tax credit operates within IRC §936 and the Treasury Regulations §1.936. California does not have a comparable tax provision to IRC §936. Generally a possessions corporation is included in a worldwide combined report. However, only in limited instances is a possessions corporation includible in the water's-edge combined report. This section will now discuss the impact of IRC §936 on the California tax system, both under the worldwide and water's-edge methods of combined reporting.

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### ***b. Worldwide Combined Reporting***

The Revenue and Taxation Code (R&TC) does not contain provisions comparable to IRC §936. Under the worldwide unitary method of taxation, all unitary affiliates are included in the worldwide combined report, including corporations electing IRC §936. In virtually all instances, a possessions corporation is created by a United States affiliate to take advantage of the federal benefits offered by IRC §936.

Technology, know-how and manufacturing processes are developed by a United States affiliate and transferred to the possessions corporation for use in its manufacturing operations. Products manufactured by the possessions corporation are usually sold by the possessions corporation to unitary affiliates, who package the product for sale to unrelated third-parties. From this profile of the typical operations of a possessions corporation, it would be virtually impossible to argue that a possessions corporation is not integrated with the operations of its affiliates, or that there is no flow of value between the affiliates.

Possessions corporations tend to be big money makers. This is due to the intangible assets involved, the low cost of production in possession countries and the offered United States and possession country tax benefits to operate in the possession country. It is not uncommon for the taxable income that is reported by the possessions corporation on its separate federal Form 1120 to be greater than the consolidated net income of the combined group as reported on the financial statements. It is this often unrealistic and distorted allocation of income that has caused possessions corporations to be the focus of federal pricing audits.

The pricing issues presented by IRC §367(d), §482 and §936(h) for federal purposes are not present in a worldwide unitary audit. The worldwide income of the unitary group is included in the calculation of the California combined income subject to apportionment, including the income attributable to the possessions corporation. The California audit issues raised by possessions corporations are no different than the audit issues presented by any other domestic corporation.

For example, book income and the book-to-tax adjustments should be analyzed and verified. State adjustments, intercompany eliminations and the apportionment factors should also be examined or reviewed. When reviewing



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the federal Form 1120 filed by the possessions corporation on a separate company basis, it is important to remember that a possessions corporation can have California factors even if its primary business activities occur in the possession country.

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### ***c. Water's-Edge Combined Reporting***

For income years beginning on or after January 1, 1988, a taxpayer can elect out of the worldwide combined reporting, and instead, can compute its income attributable to California on the basis of a water's-edge combined report. Electing to use the water's-edge method of reporting does not supersede the concept of unity; it merely limits the unitary entities included in the combined report.

As a general rule, possessions corporations are not included in the water's-edge combined report. The specific rules for excluding or including a possessions corporation in a water's-edge combined report are discussed in Chapter 2, Water's-Edge Manual.

It is important to note that possessions corporations, which have a California filing requirement (e.g., are incorporated or qualified to do business in California), must file a California franchise tax return and pay at least the minimum franchise tax. Such entities may be included in the single return of the unitary water's-edge group. Like any other California taxpayer, the possessions corporation must either make an election to file on a water's-edge basis or be included in a common parent election.

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### ***d. Identifying Possessions Corporations***

Possessions corporations included in the water's-edge combined report are subject to the same audit procedures and issues as possessions corporations included in the worldwide combined report. As noted above, however, possessions corporations are generally excluded from the combined report. As a result, possessions corporations present special audit problems. The following sections will discuss the treatment of possessions corporations. The first step, however, is to identify the existence of a possessions corporation.

Possessions corporations are common to intangible intensive industries, such as the electronics industry, the pharmaceutical industry and the software development industry, although, they can also be found in other industries. Because possessions corporations are generally excluded from the water's-edge combined report, it can be difficult to identify that an affiliated possessions corporation exists. There are numerous ways to identify possessions corporations, including the following:

1. Request an organization chart identifying all entities in the controlled group and detailing the ownership structure.
2. Review the federal Form 1118, Computation of Foreign Tax Credit - Corporations, for the taxable income attributable to Puerto Rico or the Virgin Islands. Refer to the Forms Appendix for a copy of federal Form 1118;
3. Review the foreign dividend deduction (R&TC §24411) and the intercompany dividend elimination (R&TC §25106) for dividends paid from subsidiaries operating in Puerto Rico or the Virgin Islands;
4. Review the federal Schedule M-1 for book-to-tax adjustments to reflect cost sharing payments or profit split adjustments pursuant to IRC §936(h);
5. Review the federal Form 1120 for any research and development tax credits or any research and development expenses claimed as other deductions, commissions expense or miscellaneous expenses. Once research and development expenses are identified, ask the taxpayer to identify to which projects the research and development expenses relate. Do the expenses relate to activity performed by the possessions corporation;
6. Review state adjustments for increases, reductions or eliminations of the income or deductions reported for federal purposes pursuant to IRC §936;

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7. Review Lexis, Moody's Industrial Manual and other such publications that provide information on the location of subsidiaries, property and specific business activities;
  8. Request copies of all federal Forms 1120 filed. Any corporation electing the IRC §936 possessions tax credit must file a separate federal Form 1120;
  9. Request the taxpayer to identify any affiliate operating in Puerto Rico or the Virgin Islands;
  10. Review the Domestic Disclosure Spreadsheet for any affiliate operating in Puerto Rico or the Virgin Islands, if any member of the water's-edge group meets the requirements to file these schedules.
  11. Review any SEC 10-K filings for geographic locations in Puerto Rico or the Virgin Islands.

Any one of these steps could identify the existence of an affiliate operating in a possession country. Once a possessions corporation is identified, additional audit issues arise that are discussed below.

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### ***e. Possessions Corporations With A 20 Percent Or More Average United States Factor***

#### ***1. In General***

In general, a possessions corporation is excluded from the water's-edge combined report. However, a possessions corporation with a 20 percent or more average United States factor is includable in the water's-edge combined report 100 percent.<sup>1</sup>

The 20 percent test is determined on a cumulative basis for each income year. For purposes of determining whether a possessions corporation is includable in the water's-edge combined report, the possessions corporation will compute the percentage of each United States located factor using the following rules:<sup>2</sup>

- A. For those states which assess a tax on, according to, or measured by income, and in which the possessions corporation is taxable within the meaning of R&TC §25122, the corporation computes the percentage of each factor assigned to that state applying the rules of that state;
- B. For states that do not impose a tax on, according to or measured by income, or that assign income on the basis of an apportionment formula that does not utilize one or more of the three factors (property, payroll or sales), the amount assigned to the state for any factor not used by the state would be computed applying California's rules.
- C. In those instances where the apportionment factors are not defined in a uniform manner by the state, the possessions corporation may elect to compute the factors assignable to any individual state using California's rules.

Thus, to determine if the 20 percent United States factor test is met, corporations must sum the percentages calculated for each factor under the rules discussed above. Generally, this computation will simply be a matter of adding the factor percentages as reported on the various state tax returns.

It is important to note, however, that for purposes of applying this rule, all that is relevant is that the possessions corporation is taxable in the state. It is irrelevant whether the possessions corporation actually filed in that state or whether the

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state chose to exercise its right to tax the possessions corporation. In situations where a state has a higher nexus threshold to impose tax than the threshold required by the laws and constitution of the United States, it will be necessary to calculate the factors for that state using the rules of that state. Further, in those situations where the corporation has factors in a state that does not assess an income tax or a state that does not utilize all three factors, it will be necessary to calculate one or more of the factors for that state applying California's rules.

The regulations also provide, however, that in applying the above rules no item of property, payroll or sales can be assigned in total to more than one state. For example, if two different states include the same items of sales in their respective factors, the sales will only be included once in the computation of United States located factors. The regulations are silent as to how to correct such a problem. Presumably, the factor of one of the states would have to be recalculated to eliminate the "double-counted" items.

Lastly, before any item of property, payroll or sales can be assigned to the particular state, the possessions corporation must be taxable in that state under the laws and constitution of the United States. Public Law 86-272 applies to commerce between the U.S. and Puerto Rico, so the property, payroll and sales in a state will only be considered in the 20 percent test if the possessions corporation's activities within that state exceed solicitation of orders for sales. For more information, the 20 percent or more average United States factor test is discussed in Chapter 2, Water's-Edge Manual. For an explanation of the applicability of Public Law 86-272 to Puerto Rico, see Legal Ruling 99-1. Application of the 20 percent factor test is demonstrated in this example.

### Example 1:

Corporation A, an electing possessions corporation located in Puerto Rico has the following United States factors:

	California	Oregon	New Jersey	Total
Property	6%	1%	3%	10%
Payroll	5%	2%	1%	8%
Sales	<u>32%</u>	<u>4%</u>	<u>6%</u>	<u>42%</u>
Total	<u>43%</u>	<u>7%</u>	<u>10%</u>	<u>60%</u>

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

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Assuming Corporation A's activities in each of these states exceeds solicitation of orders for sales, Corporation A would be included in the water's-edge combined report because its average United States factor equals or exceeds 20 percent.

### ***2. Property Factor***

For purposes of the 20 percent test, United States property can be determined from the corporation's fixed assets ledgers, the books and records, from tax returns filed in other states, or from other reliable sources. Property everywhere can be determined from the corporation's audited financial statements, the fixed assets ledgers, the books and records, or from other reliable sources.

Once it has been determined that the possessions corporation meets the 20 percent test for the income year, its property is subject to inclusion in the water's-edge combined report as prescribed by R&TC §25129 and R&TC §25130.

### ***3. Payroll Factor***

For purposes of the 20 percent test, United States payroll of the possessions corporation can be determined by reviewing the federal Forms 940 and 941, the books and records, from tax returns filed in other states, or from other reliable sources. Payroll everywhere can be determined from the corporation's audited financial statements, the books and records, or from other reliable sources.

Once it has been determined that the possessions corporation meets the 20 percent test for the income year, its payroll is subject to inclusion in the water's-edge combined report as prescribed by R&TC §25132 and R&TC §25133.

### ***4. Sales Factor***

For purposes of the 20 percent test, United States sales of the possessions corporation can be determined from the corporation's books and records, from tax returns filed in other states, or from other reliable sources. There are several important issues to consider when calculating the United States sales factor for purposes applying of this test:

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- A. For purposes of calculating the sales factor for any state, intercompany sales by the possessions corporation to other members of the water's-edge group are not to be taken into account in determining United States located factors. This is an exception to the general rule requiring computation of the factors using the rules of the respective states where the taxpayer has sales. In other words, intercompany sales are eliminated from the computation of the sales factor, regardless of the rules of that state.
  - B. The regulations provide that the rules for each of the different states are to be used. Throwback sales are to be included in calculating the sales factor to the extent required under the applicable state laws<sup>3</sup> except that no sale can be assigned to more than one state.<sup>4</sup>
  - C. When determining the sales factor, the sales should not be double weighted. The double weighing of the sales factor is an apportioning rule and does not change the definition of items to be included in the sales factor.<sup>5</sup>

A possessions corporation may meet the 20 percent test where sales to unrelated third parties in the United States occur. Because intercompany sales are eliminated from the sales factor, even a small volume or dollar amount of sales to unrelated parties can potentially result in 20% or greater U.S. factors. Careful analysis of third-party sales should be made regardless of whether a tax return is actually filed in any state.

However, to consider the possessions corporation's United States activities, the possessions corporation must have taxable nexus in that state. Public Law (PL) 86-272 applies with respect to commerce between the United States and Puerto Rico.<sup>6</sup> Therefore, a Puerto Rico-located possession corporation's United States activity needs to exceed solicitation of sales of tangible personal property in a particular state before sales can be assigned to that state. See Section 2.4, Water's-Edge Manual for a more detailed discussion of the 20 percent United States activity test.

### Example 2:

A possessions corporation manufactures electronic equipment in Puerto Rico. All of the property of the corporation is located in Puerto Rico. All of the payroll expense is attributable to Puerto Rico. Gross sales everywhere are \$100,000, \$99,000 of which are eliminated as intercompany sales to United States affiliates. Of the remaining sales to unrelated third parties, \$250 were sold directly to



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foreign sources, and \$750 in sales were made to United States sources. The possessions corporation is taxable in the destination state under the laws and Constitution of the United States. As a result, the possessions corporation meets the 20 percent test ( $(\$750/\$1000)/3 = 25\%$  United States factor) and must be included in the water's-edge combined report.

A possessions corporation with 100% intercompany sales will have no United States sales factor unless other items includible in the computation of the sales factor were income attributable to United States sources either under the laws of the individual states, or if elected, under California's rules and regulations (e.g., gain on the sale of assets, royalties, etc.).

Once it has been determined that the possessions corporation meets the 20 percent test for the income year, its sales and other income are subject to inclusion in the water's-edge combined report as prescribed by R&TC §25134 through R&TC §25136.

The auditor should determine whether or not the possessions corporation meets the 20 percent or more average United States factor test. If the possessions corporation meets this test, it is 100% includable in the water's-edge combined report.

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### ***f. Possessions Corporations With Income Effectively Connected With A United States Trade Or Business***

Although R&TC §25110 (a)(3) (§25110(a)(1) & (4) for income years beginning before 1996) generally excludes possessions corporations from the water's-edge combined report, a possessions corporation will be included in the combined report to the extent of any income derived from or attributable to sources within the United States and any factors assignable to a United States location.<sup>7</sup>

This rule is referred to as the "deemed subsidiary" rule and is discussed in detail in Chapter 8, Water's-Edge Manual. Note that the deemed subsidiary rule will not apply if the possessions corporation meets the 20 percent factor test discussed above. Instead, such a possessions corporation would be 100% included in the water's-edge combined report.

The United States income of such a possessions corporation would include only income which is (i) effectively connected, or treated as effectively connected, with a United States trade or business (ECI) pursuant to the IRC, and (ii) for income years beginning on or after January 1, 1992, any United States source non-ECI that is considered business income pursuant to R&TC §25120.

The auditor will need to make a determination of whether a possessions corporation has income attributable to United States sources. For federal purposes this determination is not relevant. Recall that for income years beginning prior to January 1, 1992, when determining any amount of ECI, the provisions of United States treaties must be followed. For income years beginning after January 1, 1992, we do not follow United States treaties.<sup>8</sup> Lastly, because the possessions corporation is a United States corporation, it must file federal Form 1120, NOT federal Form 1120F.

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### ***g. Intercompany Transfer Pricing***

Aspects of intercompany transfer pricing are fully discussed in Chapter 18, Water's-Edge Manual. This section briefly discusses the transfer pricing issue that specifically affects possession corporations. Many audits with a possession corporation, due to the nature of the tax-free provisions, contain a potential pricing issue.

#### ***1. In General***

This issue can result in significant audit adjustments and the potential tax effect will depend upon the overall California apportionment factor of the water's-edge group, the profit or loss reported by the water's-edge group, the profit reported by the possession corporation, and the intangible pricing method used by the possession corporation.

Although California does not conform to the federal provisions of IRC §936(h), many taxpayers report income for California on the same basis as they do under the federal profit split or cost sharing provisions. Other taxpayers attempt to eliminate the federal profit split adjustments as state adjustments to arrive at net income. Still others may attempt to make adjustments to properly reflect income based on the IRC §482 arm's length standard.

#### ***2. Required Audit File Analysis***

The auditor is required to identify and analyze any potential pricing issue in a separate program item of the audit file. The auditor is also required to make recommendations as to whether or not to pursue the pricing issue.<sup>9</sup> There are no bright-line tests to determine whether a pricing issue exists. The determination is based on the facts and circumstances of each case.

Items to be considered include:

- How much net income the possessions corporation reported on its federal Form 1120;

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- Whether the cost share or profit split method was used for federal purposes; and
  - How much net income attributable to the possessions corporation's activities is included in the California combined report.

In order to determine this information, it's important to review the possessions corporation's federal Form 1120. Although profit split or cost sharing income may be identified in the "other income" detail reported on the domestic parent's federal Form 1120, the domestic parent's return will not identify how much income is still being reported by the possessions corporation. (Even if the profit split method is used, it can be misleading to simply assume that an equal amount of trade or business income was reported by the possessions corporation. This is because the profit split computation includes a special formula for allocating R&D expenses to the possessions corporation, which may result in the income reported by the possessions corporation being less than the profit split income reported by the domestic parent.) The possessions corporation's federal 1120 will also identify whether the profit split or cost sharing method was used. Keep in mind that the possessions corporation may use profit split for one product line and cost sharing for another, or there may be more than one possessions corporation in the group.

A review of the water's-edge return and comparison against the federal 1120 should identify whether the taxpayer reported the same amount of possession income for state and federal purposes, or whether state adjustments were made to modify the possessions income reported for state purposes.

### ***3. Profit Split Method***

If the profit split method is used for federal purposes, then the taxpayer is permitted to arbitrarily attribute 50% of the "combined taxable income" (CTI) to the possessions corporation. Generally speaking, CTI is the income earned by members of the affiliated group that is attributable to products manufactured or services rendered by the possession corporation. For example, assume that a product is designed by the U.S. parent corporation, manufactured by the possession corporation in Puerto Rico, and distributed and marketed by U.S. affiliates. CTI would include the gross income from sales by the U.S. affiliates to

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third parties, less the marketing, manufacturing and R&D expenses incurred by the various members of the affiliated group.

If the federal profit split amount reportable by the possessions corporation is less than the amount of net income reported by the possessions corporation on its books, the possessions corporation will usually remit a payment to the United States shareholder. An issue for California purposes is how should this distribution be treated. This payment should probably be treated as dividend income assuming the possession corporation has sufficient earnings and profits.

If the reverse should occur and the United States parent corporation remits a payment to the possession corporation, for California purposes the payment would be treated as a contribution to capital. This would potentially affect the computation of the foreign investment interest offset since the value of the United States parent corporation's foreign investment would increase.

Further, for California purposes, rather than the arbitrary 50% profit split, the possessions corporation should only be entitled to a normal return from manufacturing under the IRC §482 arm's-length standard. This is a separate issue. If as a result of the audit, the FTB should make adjustments pursuant to IRC §482, then collateral adjustments must be considered. Collateral adjustments are discussed in the introduction section of the intercompany transfer pricing chapter. Refer to Chapter 18.1, Water's-Edge Manual for more information.

Because California does not conform to §936, RAR adjustments involving income reported under the profit split method are not applicable to California. If a taxpayer has used the cost sharing method and the IRS determines that the cost sharing payments made by a possessions corporation are less than an arm's-length amount, the IRS may opt to forego a resource-intensive §482 audit and may instead make adjustments to put the taxpayer onto to profit split method. The FTB has no authority to pick up this RAR adjustment. Our alternatives are to either recommend pursuit of a §482 audit if the issue is material, or to accept the cost sharing allocation as reported by the taxpayer.

Keep in mind that if the profit split method is used for federal purposes, the IRS will not address whether the taxpayer's intercompany pricing method meets the IRC §482 arm's-length standard. Thus, we will have a potential pricing issue whether or not the IRS is auditing the taxpayer.

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### ***4. Cost Sharing Method***

If the cost sharing method is used for federal purposes, the question that arises is whether the cost sharing payments to the entity included in the water's-edge combined report should be reversed out. For California purposes, a cost sharing payment to the United States affiliate is not required pursuant to IRC §936. It is, however, anticipated that in most instances the cost sharing payment, reducing deductible research and development costs of the United States affiliate included in the water's-edge combined report, will not be reversed out of the net income reported for state purposes by affiliates included in the water's-edge combined report (e.g., the water's-edge group will follow the federal treatment).

The cost sharing payment should adjust the developer's share of income attributable to the intangible according to the IRC §482 commensurate with income standard. Most of the income attributable to intangible property should be attributed to the developer under this method. If properly determined, the cost sharing payment would represent an allocation of income and expenses under the IRC §482 commensurate with income standard, and would not be adjusted for California purposes.

For federal purposes, the cost sharing payment is required to actually be paid to the developer. To the extent the federal cost sharing payments exceed the IRC §482 commensurate with income standard, such amounts, if paid to a parent corporation, represent dividend distributions by the possessions corporation. Accordingly, unless a dividend deduction is allowable, the amount should be included in income reported by the developer.

Other situations may arise where cost sharing payments are made to more than one affiliate, to both domestic or foreign affiliates, to unaffiliated taxpayers, or to non-taxpayers. In such instances, a determination would be required as to how to allocate the intangible property income among the entities in question. This issue would be important when the intangible asset was developed partially by an entity wholly includible in the water's-edge combined report group, and by an entity or entities excluded in whole, or in part, from a water's-edge combined reporting group.

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Keep in mind that if the cost sharing method is used for federal purposes, the IRS will address whether or not the intercompany transfer pricing method meets the IRC §482 commensurate with income standard. Thus, we will have a potential pricing issue only when the IRS is not auditing the taxpayer.

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### ***h. Dividends Paid By A Possession Corporation***

Dividends received from a possession corporation may be subject to either the foreign dividend deduction or the intercompany dividend elimination.

#### ***1. Foreign Dividend Deduction (RTC §24411)***

Dividends received from a possession corporation that has a less than 20 percent average United States factor, by an affiliate included in the water's-edge combined reporting group, are eligible for the foreign dividend deduction prescribed by R&TC §24411. For more information on the foreign dividend deduction, see Chapter 13, Water's-Edge Manual

#### ***2. Intercompany Dividends Paid From Unitary Income (R&TC §25106)***

Dividends paid by a possession corporation to a unitary affiliate may be eligible for a dividend deduction under R&TC §25106 to the extent the dividends were paid out of earnings previously included in a combined report with the corporation which received the dividend.

Only earnings and profits accumulated while the possession corporation was included in the unitary combined report are taken into account in determining whether the dividend was paid out of unitary earnings and profits. For any income year in which a possession corporation is only partially included in the combined report, its unitary earnings and profits are determined by reference to the income of the possession corporation that was included in the water's-edge combined report. For more information, see Chapter 11, Water's-Edge Manual.



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### *i. Summary*

Generally possession corporations are excluded from the water's-edge combined report, unless:

- the possession corporation's average United States factor is equal to 20 percent or more; or
- the possession corporation earns income which is effectively connected with a United States trade or business or, for income years beginning on or after January 1, 1992, any United States source non-ECI that is considered business income.

Because California has no counterpart to IRC §936(h), an excluded possession corporation will have IRC §482 audit exposure for state tax purposes that must be addressed.

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### **Footnotes**

1. California Code of Regulations (CCR) §25110(d)(1).
2. CCR §25110(d)(2)(C).
3. CCR §25110(d)(2)(C)(iii).
4. CCR §25110(d)(2)(C)(iii)(IV).
5. Legal Ruling 95-5, October 13, 1995
6. Legal Ruling 99-1, January 7, 1999
7. Revenue and Taxation Code (RTC) §25110(a)(4), formerly R&TC §25110(a)(5).
8. CCR §25110(d)(2)(G).

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